California Secure Choice
Market Analysis, Feasibility Study, and Program Design Consultant Services
(Non-IT Services)
RFP No. CSCRSIB03-14

Final Report
to the
California Secure Choice Retirement Savings Investment Board

Prepared By
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A. Background

Legislation enacted in 2012 (SB 1234, Chapter 734, 2012) authorizes consideration of the California Secure Choice Retirement Savings Program ("Program" or "Secure Choice Program"). If implemented, the Program would provide a voluntary, automatic-enrollment retirement savings plan for more than 6 million California workers who currently lack access to retirement savings plans through their employers. The Program would require private employers with five or more employees not currently offering a retirement savings plan to provide their employees access to, and payroll deductions for, Secure Choice retirement accounts. Implementation is contingent on enactment of subsequent legislation. The Program would be administered by a nine-member board, chaired by the State Treasurer and denominated as the California Secure Choice Retirement Savings Investment Board (the "Board").

Before the state legislature can consider further legislation to implement the Program, SB 1234 requires the Board to conduct a study to determine whether the legal and practical conditions for implementation can be met. The Board approved an approach to the study analysis that includes four distinct, but well-coordinated work streams:

a) Program Design – Program design narrowly tailored, as necessary or advisable, for the purposes of the market analysis, including financial feasibility study and legal feasibility study.
b) Market Analysis – A market analysis to determine likely levels of participation and elements of the Program that could maximize participation, maximize the likelihood of private sector financial providers offering products and services necessary to the Program, and minimize inconvenience or disruptions to employers.
c) Financial Feasibility Study (also referred to as "feasibility study") – A financial analysis to determine whether likely demand and participation would make it possible for the proposed Program to be self-sustaining as the statute requires.
d) Legal Feasibility Study – A legal analysis to determine whether the Program, as designed in the Program Design phase, meets legal requirements specified in the Secure Choice Retirement Savings Trust Act.

The Board contracted K&L Gates to conduct the legal feasibility study. The Board also issued an RFP seeking a contractor for the program design, market analysis and financial feasibility study work streams.

Overture Financial ("Overture") was awarded in early 2015 the contract for the RFP (the "Contract") corresponding to the program design, market analysis, and financial feasibility study work streams. The UC Berkeley Center for Labor Research and Education, BridgePoint LLC, Greenwald & Associates and Segal Consulting are sub-contractors to Overture under the Contract.

This Final Report is delivered to the Board in fulfillment of the Scope of Services under the Contract.

B. Executive Summary

This Final Report represents the culmination of many months of collaboration between Overture Financial and its sub-contractors, the Board, California Secure Choice personnel and contractors, stakeholders in the public and private sectors, service providers, employers and employer associations, worker organizations, and community groups.

We are pleased to provide this report as an actionable document that can contribute to the successful launch of the California Secure Choice Program, to the retirement security of millions of Californians and to the spread of similar programs across the nation.

The scope of work under the Contract consists of three work streams: market analysis, program design and financial feasibility study. The key findings and recommendations for each of the work streams are summarized below.

<u>Market Analysis</u>

The Market Analysis work stream consists of four parts:

(1) A market profile outlining the economic and demographic characteristics of the eligible workforce, both at the individual worker level and at the household level.
(2) Six focus groups with eligible workers—two conducted in Spanish and four conducted in English—to provide a qualitative assessment of the target population's attitudes and preferences with regard to program features, auto-enrollment, auto-escalation, and investment risk.
(3) An online survey of 1,000 eligible workers designed to yield reliable estimates of opt-out and contribution rates and gauge attitudes toward retirement savings, investment risk, liquidity and account access.
(4) Stakeholder interviews with employers and business groups, worker organizations, and consumer organizations to identify key concerns and suggestions regarding the design, rollout and implementation of the Program.

The key findings are the following:

(1) About 6.8 million workers are potentially eligible for the California Secure Choice Retirement Savings Program.
(2) Likely participation rates (70-90%) are sufficiently high to enable the Program to achieve broad coverage well above the minimum threshold for financial sustainability.
(3) Eligible participants in California are equally comfortable with a 3% or 5% contribution rate. The vast majority of likely participants are also comfortable with auto-escalation in 1% increments up to 10%.
(4) To start, the program should offer a default investment option consisting of a diversified portfolio with long-term growth potential and the choice to opt into a low-risk investment.

(5) Given its inherent portability, the Program should have a lower incidence of rollovers and cash-outs than employer-sponsored 401(k) plans, which often force workers with low balances to close their accounts. At the same time, pre-retirement withdrawals are likely to be higher for the Program given eligible workers' income profile.
(6) The Program launch should include a concerted public education campaign focused on workers and small businesses.

The table below summarizes the key recommendations.

Topic	Recommendation
Default Contribution Rate	5%
Auto-Escalation	Implement in 1% increments up to 10%, after the program has sufficiently phased in, and only if the process can be coordinated by the Recordkeeper in lieu of the employer.
Default Investment Vehicle	Diversified portfolio that offers long-term growth potential.
Access to Funds before Retirement	Limit pre-retirement withdrawals to hardship.
Account Information Access	Electronic default with paper statement option.
Employer Outreach	Develop and implement early outreach campaign to employers and payroll processors to educate them about program requirements.
Employee Outreach	Develop and implement a worker outreach program in partnership with worker organizations, unions, community organizations and asset building groups. Focus on educating employees about 1) their rights under the Program and 2) how to make an informed decision on whether to participate and how much to contribute.
Employee Protections	Institute an easy way for employees to report non-complying employers to the state. Incorporate non-retaliation language into authorizing legislation.

Program Design

The Program Design work stream consists of three parts:

(1) Investments: evaluation and recommendation of investment options for the Program
(2) Operational Model: development and recommendation of an operational model for the Program
(3) Plan Rules and Procedures: development and recommendation of rules and procedures for the operation of the Program

The tables below summarize the key recommendations for Program Design.

Investments

Topic	Recommendation
Default Investment Option At Launch	**Dynamic Asset Allocation Target Date Investment Strategy** implemented through Managed Accounts or through Target Date Funds as fallback, pending legal confirmation by K&L Gates that managed accounts are permissible. An income-focused strategy should be favored over an accumulation-focused strategy. **OR** **Pooled IRA with Reserve Fund packaged as a Retirement Savings Bond.**
Additional Investment Offering After launch	Consider a **Variable Annuity with Guaranteed Minimum Withdrawal Benefit (GMWB)** as a complementary offering in two to three years after launch once there are sufficient account balances in participant accounts.
Default Payout Method	Most DC plans default to the lump sum method, but the best policy is to orient towards lifetime income. Initially (first 3-5 years), account balances for retirees under the California Secure Choice Plan will be too small to convert into a meaningful income stream. The Board, therefore, has time to consider options before selecting a default payout method. Authorizing legislation should give the Board flexibility to determine the default payout method.
Proprietary Funds	Should the California Secure Choice Program implement the Dynamic Asset Allocation Target Date Strategy as the default investment option, we recommend creating proprietary (i.e., custom) California Secure Choice funds as investment vehicles for that option.

Operational Model

Topic	Recommendation
Operational Model	We recommend the **Direct Service Operational Model** where a single recordkeeper services employers directly without intermediation by the State of California Employment Development Department (EDD) in order to facilitate a faster launch and more flexibility in Program features. While the EDD-as-Intermediary Operational Model is less costly over the long-term (approximately 10%), the startup costs are significantly higher than the Direct Service Operational Model, the launch date is likely to be 2 years later and some features, such as auto-escalation, may not be feasible.

Plan Rules and Procedures

Topic	Recommendation
Primary Considerations	The following factors are the primary drivers of recommendations for plan rules and procedures ✓ Simplicity of administration, compliance and enforcement ✓ Minimization of the administrative and decision-making burden on employers ✓ Recordkeeping logistics ✓ Legal constraints
Rules and Procedures Subjects	The Plan Rules and Procedures fall into seven distinct areas: 1. Plan Basics 2. Definition of Employer (“ER”) 3. Definition of Eligible Employees (“EEs”) / Participants 4. Voluntary Participation 5. Auto-Enrollment and Payroll Deduction Mechanics 6. Social Security Number (“SSN”) / Identity Issues 7. Money Out

The seven sections below constitute our recommendations for the California Secure Choice Plan Rules and Procedures.

1- Plan Basics

Topic	Recommendation
Plan Year	**January 1-December 31** **ERs determine eligibility and begin notifying EEs during 4th quarter prior to each plan year.** **NOTE:** This is distinct from qualified plan year
IRA Type	**Default: Roth IRA** ✓ **Up to $5,500 after-tax annual contribution (or $6,500 if age 50+)** ✓ **Tax-free retirement withdrawals** ✓ **MAGI limit $184,000 married/$117,000 single** **Individual has choice to switch to Traditional IRA with Recordkeeper flag.** **NOTE:** Roth IRA does not require participant to file income tax deduction, unlike Traditional IRA.
Default Contribution	**5%** **EE can elect percentage or fixed dollar amount per paycheck with no minimum.**
Auto-Escalation	**Implement at Board's discretion beginning 2nd year of program, in 1% increments up 10%.** **EEs who elect contribution other than default rate prompted to opt into future auto-escalation.** **NOTE:** This will only be Implemented if operational model allows this process to be coordinated by Recordkeeper.

2- Definition of Employer

Topic	Recommendation
Plan Sponsorship Exemption	**At least 1 California EE (i.e., EE who is subject to Unemployment Insurance coverage in California and whose pay is thus reportable to the EDD) must be eligible for qualified employer-sponsored plan** in order for firm to be exempt from mandate. **NOTE:** Statutory language should be included giving Board discretion to adjust eligibility rules for ERs that do not offer meaningful coverage to most of their EEs.
Firm vs. Establishment	**ER eligibility determined at firm level.**
Firm Size (5+ EEs)	**Annual determination based on simple look-back rule.** We recommend the following criteria: average of monthly employee headcounts reported on EDD Form DE-9 for the 3rd quarter (ending 9/30) is 5.0 or higher. This data is standardized across states, and using it as part of the EE eligibility standard can help avoid duplicate payroll deductions. The fall quarter is less subject to seasonal hiring spikes than summer and winter. Include only California EEs (as defined in Eligible Employees in "Definition of Eligible Employees" below) in calculation. Statute should give Board authority to determine eligibility regulations.
Eligible Firms that Downsize to Less than 5 EEs	**Continue auto-enrollment/payroll deduction through remainder of calendar year.** The following year, ER may choose to keep contributing for EEs already enrolled but may not auto-enroll per draft DOL guidelines. **NOTE:** Request from DOL ability to grandfather ERs once they enter plan, in order to avoid creating two classes of EEs.
Employment Intermediaries (PEOs, Temp Agencies, etc.)	**Party that controls payroll (e.g. temp agency) is responsible for compliance.**

3- Definition of Eligible Employees / Participants

Topic	Recommendation
Employees	Eligible for auto-enrollment: **All EEs who are (i) EEs as defined by IRS (receive W-2) and (ii) whose pay is subject to California Unemployment Insurance taxes.** No exemption for part-time, short-term and seasonal employees. Recommended minimum age: 18 Alternatives: 19 or 20 (no higher, given employment/earnings patterns)
Owners	**Owners eligible to participate if business falls under mandate.** This includes LLC/LP partners if they have compensation eligible for IRA contributions under IRS rules.

4- Voluntary Participation

Topic	Recommendation
Employers Not Covered by Mandate	**Allow these ERs to offer Secure Choice IRA.** Under the current draft of DOL guidelines for state auto-IRAs, ERs not covered by mandate cannot auto-enroll EEs. Thus, such employers could only offer voluntary enrollment to EEs. Strong Recordkeeper control would be required to prevent ER missteps in enrollment. However, if final DOL regulations permit, employers should be allowed to auto-enroll EEs.
Self-Employed/Independent Contractors	Once the core program is running smoothly, Board should consider **allowing individuals to enroll** through paperless process and automatic ACH debits.
Voluntary Employer Contributions	Not allowed for auto-IRA program under draft DOL guidelines and current IRS rules. However, **California policymakers should consider whether the Board should have discretion to establish a Multiple Employer Plan (MEP) in the future** to receive voluntary employer match to EE contributions.

5- Auto-Enrollment and Payroll Deduction Mechanisms

Topic	Recommendation
Active vs. Passive	**Passive auto-enrollment:** ER or Recordkeeper—depending on service model—notifies EE of auto-enrollment; EE has 30 days to opt out before Recordkeeper instructs ER to start payroll deduction. **This is only feasible in the Direct Service Model.** In the EDD-as-Intermediary model, ERs would either have to be responsible for implementing the 30 day opt out process, which can be onerous, or else start payroll deduction immediately, in which case the Program would incur increased costs for issuing refunds to EEs opting out. **Remove signature requirement for enrollment purposes;** keep EE signature as proof of receipt of program info. Again, this is only advisable if the Recordkeeper directly manages the opt-out process.
EEs Who Change their Mind	**Safe harbor period of 6 months** after initial notification to terminate payroll deduction and receive refund of account balance with no transaction fee. This policy may have to be adjusted based on further determinations regarding Recordkeeper costs and Program fee structure. **NOTE:** IRA rules provide tax penalty free withdrawal of contributions made each tax year (through April 15 of following year)
Waiting Period	**None; immediate auto-enrollment.** However, Auto-enrollment/opt-out mechanics entail minimum 30-day delay before payroll deduction.
IRA Contribution Limits	**Individual is responsible** for tracking limit in relation to income. Recordkeeper flags when contributions approach standard limits; issues refund of excess.
Income Limits on IRA Eligibility	**Individual is responsible for tracking eligibility.** If ineligible based on income (small fraction of EEs): -Elect Traditional IRA (may not be pre-tax if spouse contributes to 401(k)-type plan, depending on income) or -Request refund of contributions/terminate payroll deduction.

6- Social Security Number / Identity Issues

Topic	Recommendation
Employer Role in Social Security Number (SSN) Validation	**Normal employment eligibility verification process.** **NOTE:** Include requirement for Recordkeeper to accept this as part of the RFP to select Recordkeeper.
Recordkeeper & EE Roles	**Recordkeeper performs electronic validation of identity of new enrollees; contacts EE (not ER) regarding invalid SSN.** Under the Direct Service model, no account is created, and payroll deduction for that EE does not commence until issue is resolved. **EE responsible for taking action to resolve issue** -- correct SSN/name, provide TIN, or opt out—within a 45 day period. **If no resolution or EE opts out, Recordkeeper takes no further action.** Under the EDD-as-Intermediary model, there may be a need for refunds if payroll deduction commences before the Recordkeeper has the opportunity to process SSN issues.

7- Money Out

Topic	Recommendation
Early Withdrawals	Draft DOL guidelines prohibit restrictions or penalties; we recommend requesting ability to impose requirement to self-certify hardship. **NOTE:** Awaiting legal feedback on permissibility of product/fund-level restrictions.
Loans	Not permitted under IRA rules.
Rollovers	Regular IRA rules per DOL guidelines – no restrictions.
Default Payout at Retirement	**Board should consider partial group annuity default payout as program matures and account balances build to levels sufficient for annuitization.** **NOTE:** Policy will be contingent on default investment product (e.g., Target Date Fund vs. Pooled IRA/Reserve Fund vs Target Date Fund with built-in income insurance).
Lost Accounts	**Escheat to State.** Board to determine criteria for considering an account lost (balance, number of years inactive). **NOTE:** Small, inactive accounts add to program cost.

Financial Feasibility Study

The Financial Feasibility Study work stream calls for:

(1) An assessment of whether the Program will be self-sustaining.
(2) A recommendation for the amount of funds necessary to implement the Program and the best means of financing.
(3) A recommendation of a cost and fee structure that ensures the Program is self-sustaining, simple to administer and low-cost to participants.

Our key findings are that:

(1) **The Secure Choice Program is financially viable and self-sustaining even under adverse conditions with poor investment returns and high opt-outs rates**.
(2) Total fees to participants need not exceed 1% of invested assets and such fees can decline to significantly lower levels after the first 5 years of operation, making the Program very attractive for savers.
(3) Under the conservative assumptions of the Baseline Scenario, with a default contribution rate of 5% and an opt-out rate of 25%, the Program achieves significant scale by the first year of operation with 1.6 million participants and over US $3 billion in assets. It also achieves operational breakeven by the fourth year of operation. The total funding gap—cumulative operating deficits financed at 5% interest—is moderate at US $73 million, representing less than 2.5% of program assets at the end of the first year of operation. The funding gap can be paid off by Year 5.
(4) Even under the adverse conditions of the Pessimistic Scenario, program expenses fall below 1% of program assets by the fifth year of operation. The funding gap rises to a still manageable US $129 million representing 2.7% of program assets by Year 2, 1.7% by Year 3, 1.2% by Year 4 and 0.9% by Year 5.
(5) The sensitivity analysis we performed demonstrated that financing requirements and program expense ratios are very sensitive to the default contribution rate, but the opt-out rate has a small to moderate impact below 50% and even extreme opt-out rates exceeding 80% do not materially impact the financial sustainability of the Program.
(6) Because most Program operating expenses consist of employee and employer per unit costs, employer-level participation rates do not meaningfully impact Program financial feasibility.

Our main recommendations are to:

(1) Structure the California Secure Choice Program along the lines of the Baseline Scenario in terms of the default contribution rate (5%) and a recordkeeper direct service model. In particular, program financing requirements and expense ratios are highly sensitive to the default contribution rate. A lower default contribution rate entails significantly higher startup financing.

(2) Make provisions for obtaining US $129 in startup financing even though a lesser amount is likely to obtain. Startup financing can be secured through a line of credit or loan (best option), through vendor financing (less attractive option), through higher fees to participants (undesirable option) or as a combination of the above.

Recommended Legislative Changes

- ✓ SB1234 should be amended to allow the Board to set a default initial contribution rate as high as 5%.
- ✓ SB1234 should be amended to allow the Board to implement auto-escalation of participants' contribution rates up to 10% with participant option to stop auto-escalation and change the contribution rate at will.
- ✓ The statutory requirement for employers to collect signatures to enroll employees in the Program should be removed.
- ✓ SB1234 should incorporate non-retaliation language authorizing employees to report non-complying employers.
- ✓ SB1234 should be amended to remove the 50% cap on allocations to stocks and entrust investment policy decisions to the Board subject to fiduciary constraints.
- ✓ SB1234 should give the Board flexibility to determine the default payout method (e.g., lump-sum or annuity).
- ✓ SB1234 should be amended to give the Board discretion to adjust Program eligibility rules for employers that do not offer meaningful coverage to most of their employees.

Open Legal Items Being Addressed by K&L Gates

- ✓ Permissibility of product-level lockups or restrictions under proposed DOL regulations.
- ✓ Permissibility of the managed account structure as a default investment option.
- ✓ No action letter from SEC for the Program as a whole and for specific Program investment product offerings.